

## **SEC Adopts Rule That Would Require Equity Index Annuities to Be Registered Securities**

**December 18, 2008**

### **What This Means**

By a 4-to-1 vote, with Commissioner Paredes dissenting, the Securities and Exchange Commission (SEC) adopted Rule 151A under the Securities Act of 1933 (Securities Act) on December 17, substantially as proposed. If Rule 151A survives the expected judicial challenge, it is expected to require all insurance companies issuing equity index annuities (EIAs) to register EIAs as securities under the Securities Act and sell them pursuant to a prospectus, effective January 12, 2011. An EIA is an annuity that provides annual interest equal to some or all of the return of a specified securities index, such as the S&P 500, or a minimum percentage rate specified in the annuity contract, whichever is greater. When effective, Rule 151A would require insurance agents, who currently can sell EIAs with a state insurance license, to pass FINRA tests and become registered representatives associated with a broker-dealer. In addition, EIA sales practices would become subject to the antifraud provisions of the securities laws, including Rule 10b-5. Given the current uncertainty as to how the law applies to EIAs, the rule would not apply retroactively, but only to EIA sales beginning January 12, 2011. The lengthy transition period is intended to allow EIA issuers the time necessary to implement the significant changes in their operations that the new rule requires. The rule does not address the status of those general account life insurance products whose returns are index-based.

Rule 151A was prompted by apparently abusive sales practices, such as free lunch seminars used to sell EIAs to senior citizens for whom the purchase is unsuitable. The key element of the test for EIAs is whether the return that the annuity owner receives, based on the index return, is more likely than not to exceed the minimum percentage rate specified in the contract. Based on initial discussions with insurance companies, it appears that, in almost all EIAs currently offered, the index return is the one the annuity owner is expected to receive. Accordingly, EIAs would need to be registered under the Securities Act.

### **Discussion and Analysis**

At the time an annuity owner purchases an EIA, the purchaser assumes the risk of an uncertain financial instrument in exchange for a future securities-linked return. The value of such an EIA fluctuates based on the volatility of the securities market. While EIA contracts provide some protection against the risk of loss, they do not eliminate an annuity owner's exposure to investment risk. Therefore, the protections provided for by EIAs may not adequately transfer investment risk, and the amounts paid by the annuity owner are more likely than not to exceed the amount guaranteed under the contract. Thus, a purchaser's investment is more likely than not to depend on the volatility of the underlying securities index, thereby exposing the annuity owner to risks and benefits similar to what other securities investors are confronted with.

### **"More Likely Than Not" Test**

- Rule 151A provides that a determination of the "more likely than not" test be made by the insurer at or prior to issuance of a contract, provided that (i) both the insurer's methodology and the insurer's economic, actuarial, and other assumptions are reasonable; (ii) the insurer's computations are materially accurate; and (iii) an initial determination is made no earlier than six months prior to the date on which the form of contract is first offered.

- If an insurer believes an indexed annuity is entitled to the exemption under Section 3(a)(8), the insurer bears the burden of proving that the exemption applies.

### Public Comments

There were more than 4,800 comments on the rule proposal, many of which were sharply critical of the proposal for adopting the “more likely than not” test, which the commenters asserted was a significant departure from the analytical framework the SEC and the courts, including the Supreme Court, had consistently used in analyzing the status of insurance products under the securities laws. The commenters also argued that the analysis was flawed in that it did not acknowledge the significant customer protections available under state insurance laws. The proposal was also criticized as being anticompetitive because it would require insurance companies and agencies and their agents to register EIAs as securities, the agencies as broker-dealers, and the agents with FINRA, thereby creating a series of costs that would lead some participants to withdraw from the EIA industry. Some commenters also questioned whether the SEC had exceeded its statutory authority by adopting a rule that narrowed the scope of the congressionally adopted exclusion for insurance products in Section 3(a)(8) of the Securities Act. Some or all of these criticisms would be among the bases for a judicial challenge to Rule 151A.

### Exemption from Exchange Act Reporting

The Commission also adopted new rule Rule 12h-7, which would provide insurance companies with an exemption from Exchange Act reporting, e.g., 10-Ks and 10-Qs, regarding indexed annuities and other securities that are registered under the Securities Act and regulated as insurance under state law. This rule is being proposed because these assets are regulated under state insurance law, and there is an absence of trading interest in these securities. Applying both state insurance law and Exchange Act reporting could result in unnecessarily costly duplicative regulation.

### Effect on Broker-Dealers

Under proposed Rule 151A, persons effecting transactions in indexed annuities that fall outside the scope of the insurance exemption would be required to be registered broker-dealers or to become associated persons of a broker-dealer through a networking arrangement. Thus, the selling broker-dealer and its registered representatives would be subject to the oversight of FINRA.

The SEC release adopting Rule 151A and Rule 12h-7 will include Commissioner Paredes’ dissent and will be available on the SEC’s website at <http://www.sec.gov/rules/final.shtml>.

### How Morgan Lewis Can Help

If you have any questions concerning these important legal developments, please contact either of the following Morgan Lewis attorneys:

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